

## Press release

### LCQ20: Impact of the debt crises in European countries Wednesday, November 23, 2011

Following is a question by the Hon Frederick Fung and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (November 23):

Question:

It has been reported that the European Union (EU) summit had earlier on come up with a preliminary package of solutions (including the expansion of the European Financial Stability Facility to one trillion euros, writing off the total amount of Greek debts by 50%, as well as increasing banks' capital ratio to 9%, etc.) for the sovereign debt crisis in Europe (European debt crisis), but the relevant details have yet to be implemented. The market in general is doubtful whether the package can really solve the European debt crisis, thus generating shocks in the market. In this connection, will the Government inform this Council:

(a) how the authorities assess the effectiveness of the solutions for the European debt crisis proposed by the EU summit, and the impact of the implementation of such solutions on Hong Kong's financial industry (including the insurance and banking sectors); in particular, whether serious losses will be inflicted on the banking and insurance sectors in Hong Kong by the arrangement to write off the Greek debts; and whether local banks holding eurozone sovereign bonds (especially those issued by countries such as Greece, Italy, Spain and Portugal, etc. which are facing a relatively more serious sovereign debt crisis) will have capital financing needs as a result;

(b) whether the authorities have a full picture of the risks that local banks need to face as a result of the European debt crisis; whether they

have any measure to monitor and control the relevant situation, and formulated a contingency plan to reduce the risks to be faced by local banks under the impact of the European debt crisis; and

(c) of the specific policies, proposals and corresponding measures put in place by the authorities, together with the relevant details, to tackle the worst impact that the European debt crisis may have on the economy of Hong Kong, such as the shocks and systemic risks that may be caused to the economy of Hong Kong once Greece defaults on its debts and decides to withdraw from the eurozone, as well as the potential impact of the further deterioration of the European debt crisis on the overall economy of Hong Kong, etc.?

Reply:

President,

(a) We have been closely monitoring the developments of the European debt crisis. We understand that European countries are trying to reach a consensus on the leveraging of the European Financial Stability Facility (EFSF), the recapitalisation of banks, and the write-off rate of Greek debts. In principle, a leveraged EFSF could provide more ammunitions to help troubled eurozone countries to meet their financing demand. Recapitalisation of European banks can also help build a buffer against possible losses arising from their holdings of eurozone sovereign debt and address the negative feedback between the banking sector and government fiscal problems. Practically speaking, the eurozone countries still need to cope with the challenges of reducing their structural fiscal deficits and an uncertain economic outlook. In addition, it will take time for the authorities to draw up the details of and fully implement the relevant measures. Global financial markets are, therefore, likely to remain volatile.

As regards the local banking sector, the aggregate exposure of Hong Kong's banking sector to European countries that are facing relatively more serious sovereign debt problems (viz. Greece, Ireland, Italy, Spain and Portugal) is less than 1% of the sector's total assets. This risk exposure will not give rise to capital financing needs by local banks.

Although banks in Hong Kong do not have significant exposure to debts issued by European countries facing sovereign debt problems, the banking sector may suffer from the negative spillover in the event that fiscal problems of some European countries would lead to heightened risk aversion and trigger capital outflows from emerging markets or liquidity squeeze in the interbank market.

For the insurance sector, exposure of authorised insurers in Hong Kong to Greek debt is less than 0.1% of their total investment, according to the Office of the Commissioner of Insurance. The impact of the European debt crisis on the overall stability of the Hong Kong insurance industry is therefore insignificant.

(b) As mentioned in my response to (a) above, Hong Kong's banking sector does not have a high level of exposure to the European countries with more severe sovereign debt problems. However, volatility in the global financial markets may still adversely impact the local banking sector.

Two scenarios might occur if the European debt crisis deteriorates further : (1) banks might become reluctant in lending to each other amid the concerns over counterparty credit risk, leading to tightened liquidity in the interbank market; and (2) heightened risk aversion would result in massive capital outflows from the emerging markets, causing considerable exchange rate and interest rate volatility.

The Hong Kong Monetary Authority (HKMA) will continue to monitor banks' risk exposure through its day-to-day supervision, and has requested banks to strengthen risk management and maintain adequate capital and liquidity to address the potential systemic risk arising from the global financial turmoil.

To address the potential credit crisis arising from the global financial market turmoil, the HKMA stands ready to provide liquidity assistance to individual banks if needed and on a case-by-case basis, through the use of foreign exchange swaps and term repos. These measures were utilised following the collapse of Lehman Brothers and managed to relieve tension in the interbank market during the period.

If the Hong Kong dollar exchange rate falls and reaches the weak-side

Convertibility Undertaking level due to massive capital outflows under heightened risk aversion, the HKMA will conduct operations under the Currency Board arrangements, using the foreign reserves accumulated from inflow of capital earlier as a buffer to maintain exchange rate stability and mitigate excessive interest rate volatility.

(c) At this juncture, there remains much fluidity in the European sovereign debt situation, posing downside risks to the global economy. Hong Kong's economic performance next year will hinge crucially on how the European debt crisis will evolve and impact on the global economic landscape. As the EU is the largest economy in the world and also an important export market for Asia (Hong Kong included), any further escalation in the debt crisis would necessarily deal a severe blow to the global economy. Hong Kong as a small and open economy will inevitably feel the pinch.

In face of the uncertain external economic outlook, the Government will stay highly vigilant and closely monitor the developments on the external front. We will, as in the past, stand ready to mobilise the necessary resources and get well-prepared to cope with developments in the global economic environment. We will introduce timely and effective measures to tide the trade over when necessary. The Secretary for Commerce and Economic Development, in his reply to Hon Lam Tai-fai's oral question on November 9, has provided information on support measures for our businesses, particularly the small and medium enterprises.

Ends